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Tax Features

Foundation Testimony to Ways & Means Committee Urges Removal of Burdens On Multinational Operations

On July 22, 1992, Floyd L. Williams, Chief Tax Counsel of the Tax Foundation, appeared before the House Committee on Ways and Means, on a panel with representatives from the American Bar Association, Tax Executives Institute, and the National Association of Manufacturers, to present the Foundation's views on H.R. 5270, "The Foreign Income Tax Rationalization and Simplification Act of 1992." That bill contains several provisions that are designed to eliminate excessive burdens placed on U.S. multinational corporations in conducting business abroad and several provisions designed to extract more U.S. tax from foreign-owned businesses conducting business in the U.S. and foreigners holding certain domestic investments.

Tax Foundation Chief Tax Counsel Floyd L. Williams, III presents the Foundation's testimony to the House Ways and Means Committee.

Williams noted, at the outset, that "to some extent the U.S. through its tax policy has placed its own multinational corporations at a disadvantage by imposing more severe restraints and heavier tax burdens on foreign source income than have several of its trading partners. Moreover, the frequent changes in, and complexity of, the tax law can be a disadvantage to our multinationals because of the high cost of tax compliance."[1] Williams further stated that the Tax Foundation believes that "just as U.S. multinationals should not be placed at a disadvantage, U.S. tax policy should not impede

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TAX FOUNDATION

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FRONT BURNER

Benefits of Possessions Tax Credit Should Be Extended, Not Curtailed

Representative Phillip M. Crane

On June 21 and 22, 1992, the House Ways and Means Committee held hearings on H.R. 5270, "The Foreign Income Tax Rationalization and Simplification Act of 1992." That legislation, which is quite comprehensive, contains several proposals that are designed to assist U.S. multinational corporations in conducting business abroad. However, it also contains some provisions that are not so beneficial to U.S. multinational corporations, as well as provisions designed to increase the taxes of foreign enterprises conducting business in the U.S.

The provision of H.R. 5270 that most concerns me is the proposal to reduce the Puerto Rico and possession tax credit (Internal Revenue Code section 936) from 100 percent to 85 percent of pre-credit U.S. tax on a company's possession-based operations and qualified possession source investment income. Currently, the Puerto Rico and possession tax credit provides a 100-percent tax credit against U.S. income tax for business income and qualified passive investment income earned by certain U.S. corporations operating in U.S. possessions (so-called "section 936 corporations"). The section 936 credit is a deliberate departure from capital export neutrality. Its purpose is to provide an incentive for U.S. corporations to invest in certain U.S. possessions and, thereby, increase employment in those possessions. Most section 936 corporations operate in Puerto Rico. However, the credit is also available with respect to U.S. business operations in the North-

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Phil Crane, Republican from Illinois, serves on the House Ways and Means Committee and is the ranking minority member of its Subcommittee on Trade.

The opinions expressed in the Front Burner are not necessarily those of the Tax Foundation. Editorial replies are encouraged.

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ern Mariana Islands, Guam, the U.S. Virgin Islands, American Samoa, and the Federal States of Micronesia.

Although section 936 has come under some criticism lately, the operation of the section 936 credit is still the most cost effective and successful way to promote economic development within the U.S. Commonwealth of Puerto Rico. As my friend and colleague, Antonio Colorado, Puerto Rico's resident commissioner, has pointed out, section 936 is critical to the vitality of the Puerto Rican economy, and has helped to create more than 150,000 jobs on the U.S. mainland. He also noted that in 1991, $21.3 billion

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worth of products exported by Puerto Rico was equal to 65.7 percent of its entire gross domestic product, and that most of these exports were from section 936 manufacturing companies. I am concerned that any adverse changes to section 936 could have rather negative consequences for the Puerto Rican economy.

The value of section 936 was recognized as recently as 1986 when the Caribbean nations were granted access to section 936 funds. I believe that allowing the Andean countries of Bolivia, Peru, Columbia, and Ecuador to have access to these same benefits would be an excellent way to stimulate their economies while, at the same time, helping to reduce the supply of drugs flowing out of the Andean region. Moreover, allowing this access will involve no cost to the American taxpayer.

Last year, Congress unanimously passed the Andean Trade Preference Act, which I introduced. That act grants duty-free treatment to imports from the Andean region in an effort to provide legitimate alternatives to coca production. However, without the necessary capital investment to create new jobs,

Allowing the Andean countries of Bolivia, Peru, Columbia, and Ecuador to have access to these same benefits would be an excellent way to stimulate their economies while, at the same time, helping to reduce the supply of drugs flowing out of the Andean region. Moreover, allowing this access will involve no cost to the American taxpayer.

unilateral tariff reductions, by themselves, cannot eliminate the drug problem. New productive investment is central to the strategy of developing alternative income-generating activities that will result in the creation of desperately needed jobs. Without new investment, tariff reductions become much less effective. The extension of section 936 benefits to the coca-producing South American countries would create a catalyst for new investment, leading to more jobs and critical labor alternatives for farmers who are currently employed in the drug trade. In fact, the extension of low-interest

The extension of section 936 benefits to the Andean countries would complement the Enterprise for the Americas Initiative (EAI) to promote economic growth and political stability in Latin America and the Caribbean.

loans to the qualified Caribbean Basin Initiative countries in 1986 created approximately 20,000 new private-sector jobs as a result of nearly $650 million in section 936 investments allowed by Puerto Rico.

Furthermore, the extension of section 936 benefits to the Andean countries would complement the Enterprise for the Americas Initiative (EAI) to promote economic growth and political stability in Latin America and the Caribbean. Over the past decade, countries in Latin America and the Caribbean have confronted an economic crisis that has resulted in lost trade, fewer markets, and reduced investment opportunities for the U.S. One of the pillars of the EAI is the

The Andean Trade Preference Act ... grants duty-free treatment to imports from the Andean region in an effort to provide legitimate alternatives to coca production. However, without ... new investment, tariff reductions become much less effective. The extension of section 936 benefits to the coca-producing South American countries would create a catalyst for new investment, leading to more jobs and critical labor alternatives for farmers who are currently employed in the drug trade.

promotion of investment in Latin America and the Caribbean, which could be accomplished through my proposal to extend low interest loans to the Andean countries. The extension of section 936 benefits to Bolivia, Columbia, Peru, and Ecuador would serve the goal of further strengthening the economic and political forces of the Western Hemisphere.

The enactment of the Andean Trade Preference Act signalled Congress's commitment to the eradication of America's drug problem. By coupling this commitment with an extension of section 936 benefits to the Andean nations, we can more aggressively pursue this goal and, at the same time, help to forge a new relationship with our Latin American neighbors. ■

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foreign investment or business activity in the U.S.," and that "recent U.S. tax policy regarding foreign investment in the U.S. has come under criticism both from foreign and U.S. sources."

"Like most comprehensive tax legislation," said Williams, "H.R. 5270 has

Testifying with Foundation Chief Tax Counsel Floyd Williams were, from left: Paul R. Huard of the National Association of Manufacturers, Peter L. Faber of the American Bar Association's Section of Taxation, and Jo-Renée Hunter of the ABA's Committee on Foreign Activities of U.S. Taxpayers.

positive provisions and negative provisions. In the positive category are the proposed interest allocation rules and the removal of limitations on the alternative minimum tax foreign tax credit. The

Just as U.S. multinationals should not be placed at a disadvantage, U.S. tax policy should not impede foreign investment ... in the U.S.

negative provisions include the repeal of deferral of income for controlled foreign corporations and the proposed minimum tax on foreign-owned U.S. corporations. "If deferral were repealed," he continued, "then some U.S. multinationals might find it more difficult to compete in the world market because foreign-owned subsidiaries in other countries could still benefit from tax incentives in various countries and from manufacturing goods in low-tax countries." Noting that our trading partners have considered some recent U.S. tax policy moves to be treaty overrides, Williams stated that "the proposal to increase tax on foreign-owned U.S. corporations could have the effect both of reducing foreign investment in the U.S. and inviting retaliation from foreign governments."

In the Ways and Means Committee chamber, Williams chats with officers of the Tax Executives Institute: from left, Reginald W. Kawalchuk, International President; Michael J. Murphy, Executive Director; and Timothy McCormally, General Counsel & Director of Tax Affairs.

Williams cautioned the committee that "when considering comprehensive legislation such as this, each provision should be analyzed in terms of whether it is helpful or harmful to U.S. industry. One must also ask whether it makes

Some of the members of the Ways and Means Committee present for Tax Foundation testimony: from right, Chairman Dan Rostenkowski (D-IL), J.J. Pickle (D-TX), and Charles B. Rangel (D-NY). Back row: Committee staff attorney Harrison Cohen.

sense to enact benefits for some of our multinationals at the expense of other U.S. multinationals and foreign multinationals. If, in fact, our foreign trading partners were to retaliate against U.S. multinationals as a result of enactment of H.R. 5270, then any of its intended benefits would be largely negated."

Williams' testimony concluded with the offer to "assist the committee in studying ways to eliminate burdens on U.S. multinationals in a way that does not pit some U.S. multinationals against others or pit U.S. multinationals against foreign multinationals. ■

Presidential Candidates Unveil Policy Agendas

by Christopher Nelson

Presidential candidates George Bush and Bill Clinton and almost-candidate Ross Perot have recently added specifics to their economic agendas. Their ideas on deficit reduction, tax changes, regulatory reform, trade policy, spending reductions, and other major economic initiatives (see pp. 4-5) are gleaned from public statements, campaign literature, and staff interviews. Revenue estimates are presented where possible.

George Bush opposes tax increases to reduce the deficit, professing a belief that lower federal outlays and strong economic growth will suffice. He supports a balanced budget amendment and advocates some new programs for the private sector (e.g., tax incentives for

Deficit Projections for Presidential Candidates' Economic Plans
Fiscal Years 1993 – 1996
$Billions

	'93	'94	'95	'96
Bush	341.0	274.2	218.4	217.7
Clinton	295.7	243.0	174.0	141.0
Perot	–	212.3	97.1	35.8

real estate, health insurance, enterprise zones, and research and development).

Bill Clinton would increase spending $200 billion over four years while trying to halve the federal deficit, spending these new funds on infrastructure, urban programs, education, and health care. He would finance these initiatives by cutting $300 billion in defense, closing corporate "tax loopholes," raising taxes on the "rich," controlling health care costs, and cutting 100,000 federal jobs.

Ex-candidate Ross Perot's economic plan combine new taxes and spending cuts to promise a budget surplus by 1998. DRI/McGraw Hill says it would boost exports, reduce long-term interest rates, and add $1 trillion in private investment over ten years. It would offer investment incentives such as capital gains tax cuts and business tax credits, cut federal programs such as Medicare and Medicaid, and raise other taxes.

See chart on pp. 4-5

Christopher Nelson is a Charles G. Koch Charitable Foundation Summer Fellow at the Tax Foundation.

	Federal Deficit	Personal Taxes	Business Taxes	Education Reform	Regulation
George Bush	• Enact a balanced budget amendment. • Control the deficit through a total freeze on domestic discretionary spending and domestic federal employment, a line-item veto, and the elimination of 246 Federal programs. • Proceed with orderly cuts in defense. • Establish spending caps on subsidy programs.	• Reduce the capital gains rate to 15.4% (increase revenue by $6.5 billion), increase the exemption for children by $500, allow a first time home buyer to take a tax credit of up to $5,000 (costs $5.4 billion), allow penalty-free IRA withdrawals for first time home buyers (costs $418 million), and make capital losses for home sellers deductible. • Eliminate tax deferral on the internal growth in value for most individual annuities. • Allow write-offs for health insurance premiums.	• Disallow the tax deductions for interest on policy loans for corporate-owned life insurance (save $1.7 billion). • Require depreciation recapture. • Restore the real-estate passive loss deductions for owners/developers. • Make permanent the R&D tax credit (costs $1 billion a year). • Low-income housing credit (costs $1.2 billion). • Investment tax allowance for newly acquired equipment (save $3.7 billion) and a targeted jobs tax credit (costs $455 million). • Simplify and enhance AMT depreciation (costs $1.1 billion).	• Expand the Department of Education's budget by $1.6 billion. • Favors national teacher testing, training for science and math teachers, a voucher system, and an increase in the Head Start Program. • Provide universal access to college loans. • Allow a deduction for interest paid on student loans (costs $2.6 billion). • Make government Pell grants available to part-time students (estimated 100,000 more Pell grants per year).	• Imposed a 90-day moratorium on new regulations. • Federal agencies should use cost/benefit analysis to examine all regulations. • Allow more rapid approval of safe new biotech products. • Allow banks to diversify their operations across state borders. • Establish an Interagency Affordable Housing Regulatory Review Board to expedite waivers to Federal regulations. • Supports the concept of a "regulatory" budget to limit the imposition of new regulations.
Bill Clinton	• Divide the budget into three parts: current services, service debt and bank failures, and investments in the future. Clinton would then limit current services, which includes most entitlement programs, to the rate of increase in personal incomes while doubling the investment budget to 18% of all federal spending. • Cut the current deficit in half within four years. • Use line-item veto to cut pork barrel projects by $9.8 billion. • Wants our allies to help pay for U.S. defense services (i.e., Germany, Japan).	• Raise the highest tax rate to about 38% on those earning over $200,000, impose a surtax on millionaires, and increase the individual alternative minimum tax (raise $82.9 billion). • Taxpayers could replace the $2,150 tax exemption per dependent with tax credit of $800 per child (saving them up to $480 per child) or a tax cut of 10% for the middle-class, but not both (costs $13 billion a year). • Expand the refundable earned income tax credit. • Cut capital gains tax rate by 50% for profits from long-term investments in new businesses (costs $200 million a year). • Fully tax Social Security benefits for the wealthy. • Opposes write-offs for health insurance premiums.	• $2 billion more in investment tax credits for new businesses. • Raise taxes $70 billion on corporations. • End deductions for investment overseas (save $1.5 billion). • Heavier taxation of U.S. subsidiaries of foreign corporations (raise $45 billion). • Make the R&D tax credit permanent (costs $1 billion a year). • Eliminate corporate tax breaks for "excessive" executive salaries (save $1.3 billion). • A tax credit for investments in plant and equipment for small and medium size businesses (costs $400 million a year). • Increase fines and taxes for corporate polluters (raise $10.1 billion) and give tax breaks for corporate recycling. • Eliminate tax breaks for certain drug companies and end the deduction for special interest lobbying expenses (save $400 million).	• Backs a national exam system, annual evaluation of all schools, $1 billion national apprenticeship system for high school graduates, reduced class size, and college loans for everyone that are to be paid back as a percentage of future income or through civil service (estimated to cost $14 billion a year, with 43% being recovered by eliminating the current $6 billion a year Federal student loan program). To pay for this program, Clinton wants to create an $8 billion national trust fund. • Fully fund the $5 billion Head Start program and make it available to all eligible 3 and 4 year-olds. • Require companies to spend 1.5% of their payroll to train workers or to contribute to a government training fund.	• Increase government regulation of employee-employer relations (requiring more "mandated benefits" and worker re-training). • Impose new regulations on the ability to transfer environmentally-safe portions of military bases to private sector uses. • States that he would "make sure federal regulators send a clear signal to the financial community not to call in loans that are performing, and not to fear making good loans to local businesses." • Require financial institutions to invest in their communities. • Minimize federal regulations in urban enterprise zones to give businesses an incentive to locate in inner cities.
Ross Perot (withdrew 7/16)	• Eliminate the deficit and create a budget surplus by 1998. • Prohibit deficit spending by the government. • Require that taxes cannot be raised without a national referendum.	• Include 85% (instead of 50%) of Social Security benefits in income (raise $7.9 billion). • Increase gasoline tax 10 cents a year for five years (raise $50 billion). • Cut capital gains tax rate. • Double federal taxes on tobacco (raise $3.8 billion). • Increase highest income tax bracket from 31% to 33% (raise $7.6 billion). • Limit mortgage interest deductions to $250,000 of mortgage debt (raise $4.6 billion). • Eliminate "bubble" effect of levying higher marginal tax rates on the upper-middle-income than on the wealthy.	• Calls for a 10% tax credit on increases in investments by businesses, that are unexpected. • Tax credit for business expenditures on worker training. • Reduce the deduction for entertainment expense from 80% to 50%.	• Increase federal spending on education, cities, and research and development by $60 billion over 5 years. • In Texas, Perot supported equality of funding for school districts, reduced class size, improved early-childhood education, a longer school year, achievement testing, teacher-competency examinations, and merit pay.	• Blamed savings and loan situation on Bush's oversight of the deregulation of financial services during Reagan administration. • Led Texas's "War on Drugs," that yielded mandated harsher sentences and more wiretapping. • Stated that his company stopped dealing with federal government due to flawed bidding process, extensive bureaucracy. • Eliminate PAC money, soft money, from campaigns.

Where provided, revenue estimates cover fiscal years 1992–1996.

Health Care	Trade	Other New Programs	Program Reductions
• A tax credit of up to $3,750 to help lower-income individuals buy health insurance. • A National Medical Billing System that he estimates will save $4 billion the first year. • Facilitate the purchase of health insurance plans for small employers and centralize the administrative system that handles health care claims. Projected new tax breaks would cost the government $100 billion over the next five years. • Limitation on malpractice awards. • Penalty-free IRA withdrawals for medical expenses. • Expansion of Community and Migrant Health Centers.	• Supports Uruguay Round of GATT to lower international trade barriers (costs $20 million). • Supports North American Free Trade Agreement (NAFTA) to open Canadian, Mexican, and U.S. markets to each other's exporters and investors. • Vigorous enforcement of U.S. laws to prevent "unfair" trade practices in the United States. • Signed bilateral investment treaties (BITs) with Czechoslovakia, Argentina, and Poland. • Has concluded numerous trade agreements with Japan and wants to expand the Structural Impediments Initiative (SIC) to further open the Japanese market. • Calls for more agricultural export subsidies.	• A nominal 3 percent increase in research and development funding for fiscal 1993 (costs $76.6 billion). • Spend $5.4 billion for the Strategic Defense Initiative (SDI) and the theater missile defense system. The proposed spending would be an increase of 31% for the program. • Pension investment reform that could create an additional $100 billion in real estate investment. • Welfare reform that would require able-bodied people to work and would simplify the process for experimentation of new welfare ideas by the states. • Supports offshore drilling and simplification of nuclear plant licensing. • Extend unemployment benefits and increase credit availability by allowing banks to operate across state lines. • Supports enterprise zones that encourage investment in economically-distressed areas. • Spend $2.8 billion on Head Start, $500 million on Weed and Seed Program, and $28.5 billion on anti-crime/drug abuse. • Requests over $1 billion in homeless assistance and $12.7 billion for the war on drugs.	• Cut defense spending by $50 billion over the next five years, while fully funding SDI. • Reduce Medicare spending by $1.3 billion more than will result from the existing 5-year budget agreement. • Advocates a reduction in the voluminous amount of federal regulations that are estimated to cost the taxpayer between $300 and $400 billion a year in compliance costs.
• National health-care system. He favors a play-or-pay system of compliance. Clinton would have employers insure their workers or pay an additional tax into a public fund to cover those who are uninsured. • Increase Medicare-B costs for individuals with annual incomes that exceed $125,000 (save $4.4 billion). • Expand Medicare to include long-term care. • Believes that affordable, quality health care should be a right, not a privilege; and he would require all businesses to pay a set amount per employee to spread risks evenly among all companies. • Require insurance companies to sell health insurance to all businesses. No individual could be denied insurance due to pre-existing conditions.	• Extend free trade. States that "protectionism is just a fancy word for giving up." • Favors the "fast track" negotiations on a free-trade agreement with Mexico that protects workers rights and environmental standards. • Believes "25 percent" of U.S. economic problems are caused by unfair Japanese trading practices and the rest by the Republican administration. • Pass a stronger Super 301 trade bill, "acting swiftly" if trading partners do not abandon unfair trading practices. • Would toughen lobbying disclosure laws and require senior government officials, who work for a U.S. Trade Representative, to pledge not to lobby for foreigners. • Wants to reduce the trade deficit through an energy policy which reduces imports through the research and development of alternative energy sources. • Wants to increase the funding for the Export-Import Bank, which is designed to assist small businesses develop export markets.	• Invest more than $50 billion a year over the next four years on put America back to work plan. • $20 billion a year infrastructure program that is part of a larger inner city plan. • Supports a government contribution of as much as $7 billion a year in investments between the government and the private sector and provide subsidies in fields like communications, high speed trains, aerospace, silicon wafers, new materials, and biotechnology. • Increase the nation's police force by 100,000 over the next few years. • Create more than 200,000 jobs, including 45,000 construction jobs, by accelerating spending on last year's highway bill. • Start a multibillion-dollar-a-year civilian research and development agency. • Create an Economic Security Council to coordinate America's international economic policy. • Raise the ceiling on mortgage guarantees for first-time home buyers. • Pressure banks to lend more and plans to raise their taxes. Clinton would also aid first-time home buyers. • Backs boot camps for juvenile offenders and would force welfare recipients to work after 2 years. • Spend $3.4 billion to build two Seawolf attack submarines that Bush cancelled. • Fund the space station. • Supports mandatory family leave option for employees.	• Eliminate 100,000 federal jobs through attrition (saving $15.3 billion). • Reduce the administrative cost of government by 5% a year (saving $75 billion). • Cut defense by 40% saving $100 billion in five years. • Cap federal health spending and use means-testing for Medicare. • Opposes federal research and development of new nuclear power plants. • Cut the White House staff by 25% to save $10 million a year.
• Contain Medicare and Medicaid costs (saving $52.8 billion). • Tax employer-paid health-care premiums for family coverage that exceeded $335 a month (raise $15.9 billion). • Test a couple of approaches to health care reform on a small scale, choosing the approach that generated the best results to be implemented nationally.	• Cited the inequity of wages, health care, benefits, etc. between the U.S. and other nations (i.e., Mexico) as an argument against free trade. • Opposed the North American Free Trade Agreement. • Blamed American trade negotiators, who often end up lobbying for the nation they dealt with, for the nation's unfair trade agreements. • Advocated tough trade policies toward Japan and other foreign competitors. For example, he would have given Japan the same "deal" on auto imports that they gave the United States.	• Invest $40 billion over 5 years on infrastructure projects (e.g., roads and new telecommunication systems). • Government cooperation with business — creating long-range strategic plans for each industry, pursuing tough trade negotiations, and granting government subsidies. • Institute a national system of "electronic town halls" where he could have explained the major political issues and the legislative choices that were available. Citizens could then choose alternatives through interactive cable T.V. and telephone voting.	• Cut discretionary programs by $53 billion (using a 10% across the board budget cut for most programs). • Cut military spending by $40 billion more than President Bush proposes over the next five years. • Make large cuts in the funding of mass transit and arts programs. • Eliminate the proposed space station. • Cut farm subsidies by $17 billion over the next five years.

Kasten Keeps Plugging for Balanced Budget/Tax Limitation Amendment To Control Federal Spending

On July 16, 1992, Tax Foundation economist Paul G. Merski interviewed Senator Bob Kasten (R-WI) about his thoughts on the nation's fiscal crisis and his proposed Balanced Budget/Tax Limitation Amendment to the United States Constitution.

Q Tax Foundation research shows that the overall tax burden on Americans is at a record high, yet federal spending and deficits continue to command an even greater percentage of our nation's income. How can this trend be reversed?

A I believe the key is to get federal spending under control. Federal spending skyrocketed in the last decade. It has outstripped reasonable levels of growth and has forced a growing deficit and tax burden on working Americans. In 1992, federal spending will increase 11 percent. During the 1980s, tax revenues jumped 72 percent, but federal spending rose 85 percent, a growth rate twice the level of inflation during the decade. A balanced budget/tax limitation amendment will force Congress to rein in spending. Congress should also grant the President line-item veto authority.

Q The idea of a constitutional balanced budget amendment is not new. In fact, it was formally proposed back in 1935. What is your rationale for the need to get a balanced budget amendment now?

A The Congress has demonstrated a total inability to control spending. This year the deficit will reach $400 billion and the total debt burden will be $4 trillion. The interest payment on this debt now takes 15 cents of every federal tax dollar sent to Washington. The real problem however, is the total size of government. This year, the federal government will spend 25 percent of the total income of the country. This is the highest level since the end of World War II. This record spending has been accompanied by sharp tax increases. By requiring a balanced federal budget and limiting the growth in taxes, a balanced budget/tax limitation amendment will force government to live within its means.

Q How is your balanced budget amendment proposal different from the recent House version that fell nine votes shy of passing, and does it have the "teeth" to make it work?

A My amendment would require a 3/5ths supermajority vote of the Senate and House in order for the rate of growth in taxes to exceed the rate of growth in national income. This is the same 3/5ths vote that the amendment requires in order for the Congress to run a deficit. The alternative amendment you mentioned lacks this parity, requiring a simple majority to raise taxes. Without supermajority vote protection, Congress will find it all too easy to continue its spending binge. Then, at the end of the year when a deficit is looming, they can simply raise taxes and blame it on the Constitution. The difference between the two versions of a balanced budget amendment is very clear: by making it tough to raise taxes, the Kasten version would result in spending restraint as the means of balancing the budget, the alternative would likely result in new tax increases.

Q Earlier this year, you had also put forth an economic growth and family tax relief proposal that called for a capital gains tax cut, IRA expansion, and a child tax credit. Would this type of plan help us grow our way out of the annual deficit situation?

A It certainly would. The severity of the deficit has been greatly increased by the recession. Any plan to reduce the deficit must be accompanied by a package of pro-growth tax cuts. This should include a capital gains tax cut, expanded IRAs, improved depreciation, passive loss relief, family tax relief, and enterprise zones. This will ensure the job creation and business expansion that will boost economic growth. The Congressional Budget Office has determined that if economic growth is increased one percentage point above current forecasts over five years, the deficit will be reduced by $258 billion. Recent history shows how important economic growth is to reducing the deficit. After declining from 6.5 percent of GDP to three percent during the low-tax, high growth period of 1983-1989, the deficit is now projected to reach almost seven percent of GDP in 1992 following a massive tax hike and several years of anti-growth policies.

Q Americans are still paying the increased taxes from the 1990 budget agreement that called for $164 billion in new revenues over five years intended to help reduce the deficit. Unfortunately, the deficit will be over $400 billion this year. Do you think additional tax increases are fueling the problem?

A Definitely, the people of Wisconsin and individuals all across the U.S. are tired of Congress's repeatedly raising their taxes only to increase spending and produce even greater deficits. In recent years tax hikes have repeatedly been justified on the grounds that they will reduce the deficit. Tax increases have not reduced the deficit, they have merely encouraged Congress to spend more money. This is confirmed in a new study by Richard Vedder, Lowell Gallaway, and Christopher Frenze titled "Taxes and Deficits: New Evidence." This study concludes, based on an analysis of 1947-1990 data, that each $1.00 of tax increases leads to $1.59 of new spending.

In the 1982 budget deal, Congress promised $3 in spending cuts for each $1 in tax hikes. The actual result was a dramatic spending increase. In 1990, the so-called budget summit deal imposed a massive tax increase on the American people. All in the name of reducing the deficit. And what was the result? Tax revenues fell dramatically — and the deficit went up instead of down. When the agreement was enacted 18 months ago, the deficit for 1992 was supposed to be $229 billion; it will in fact be closer to $400 billion. Similarly, the 1993 deficit forecast has grown by $223 billion. The reason is clear: in addition to encourag-

ing more spending, tax increases depress the economy, destroy jobs, and ensure that a balanced budget continues to elude Congress.

Q You have been calling for more "dynamic" revenue estimates to replace the "static" estimates you feel are inadequate to properly measure the true impact of federal tax policy changes. Are these dynamic estimates attainable, and can they improve fiscal policy decision making?

A I believe that one of the greatest obstacles to enacting a pro-growth tax package is "static" revenue estimates. For example, opponents of a capital gains tax cut continually use static revenue estimates to support the claim that the proposal would increase the deficit. This is completely contrary to history and to logic. A capital gains tax cut will lower the cost of capital, increase job creation and business expansion, and boost the level of economic growth. In the process, revenues to the federal government would increase. This fact is recognized by numerous private sector economists who understand the "dynamic" effect of the proposal.

Another example of the tragedy of static revenue estimates is the recent luxury tax placed on boats. The Joint Tax Committee claimed that this tax was a revenue raiser but completely ignored the economic damage that would result from the tax. It is estimated that 19,000 boat builders lost their jobs in 1991 alone due to this tax. Therefore, the tax is actually costing the government more in lost income tax, payroll tax revenues and unemployment payments than it is raising.

Q In the past 30 years, the federal budget was balanced once and taxes were increased 56 times. With those 56 to 1 odds, what chance is there that American taxpayers will see a balanced budget anytime this century?

A The American people are tired of business as usual. They support a constitutional amendment and they are tired of high taxes and spending. Congress is starting to get the message. However, without the discipline imposed by a balanced budget/tax limitation amendment like the one I propose, I fear that Congress will largely continue its out of control spending habits. ■

FOUNDATION MESSAGE

Will Perseverance Pay Off for the Real Estate Lobby?

Floyd L. Williams, III
Chief Tax Counsel

Before enactment of the Tax Reform Act of 1986, the tax treatment accorded to rental real estate was generally quite favorable. The 1986 tax act, however, shifted tax benefits away from real estate and toward general tax rate reduction. The most significant changes, insofar as the real estate industry was concerned, included repeal of the capital gain tax differential, lengthening of depreciable lives for real property, and imposition of the passive activity loss restrictions.

The many tax advantages that were available in connection with rental real estate prior to the 1986 tax act had the cumulative effect of reducing the risks inherent in new construction, facilitating the financing of large-scale developments, maintaining rental investment during inflationary times, and reducing the rents required to provide investors with a competitive rate of return, adjusted for risk. These tax benefits also encouraged the rapid development of partnership syndications through which individuals were able to deduct losses that significantly exceeded their out-of-pocket cost for the investments. These losses were used to offset income, such as salaries, dividends, interest, etc., that was unrelated to the real estate investments.

It would appear that the Congress went too far in 1986 when it singled out rental real estate for harsher treatment than any other type of business activity under the passive activity loss limitations, which generally require the matching of losses from a "passive activity" with income of the same type. Taxpayers who are "material participants" in any business activity other than rental real estate are not restricted under the passive activity loss limits.

President Bush's State of the Union Address last January was a cause for celebration by the real estate industry. Among the proposals intended to stimulate the real estate sector of the economy were reduction of the capital gain tax, enactment of a first-time home buyer credit, penalty-free IRA withdrawals for first-time home buyers, increased pension fund investments in real estate, deductions for losses on sales of personal residences, extension of the mortgage revenue bond program and low-income housing tax credits, and passive activity loss relief.

While it is doubtful that Congress will enact all of the real estate industry's "wish list," it looks like passive activity loss relief is a real possibility this year. H.R. 4210, as passed by the House and Senate, but vetoed by President Bush, contained some measure of passive loss relief for rental real estate. However, it did not go as far as the industry would have liked because, among other things, losses generally would have been capped at 80 percent of income and relief would have applied only to existing properties, not new construction.

Notwithstanding the demise of H.R. 4210, the real estate industry has new cause for hope with the House's passage of H.R. 11. That bill would provide relief for taxpayers more than one-half of whose personal services are performed in real property trades on businesses in which they materially participate. The provision would apply to individuals involved in real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage. Moreover, it would apply to new construction, as well as to existing properties.

The real estate industry, which began its effort to achieve passive loss relief almost before the ink was dry on the 1986 Tax Act, can finally see light at the end of the tunnel. This may be a case where perseverance finally pays off.

Two-Day Workshop on Transfer Pricing at NYU Brings Corporate and Academic Expertise to Congressional Staff

The Tax Foundation and New York University sponsored a transfer pricing workshop May 28-29 in New York City. The audience was a mixture of executives and professors with transfer pricing expertise and congressional staff seeking to enhance their expertise.

Speakers not pictured were David Rosenbloom and Pat Lewis of Caplin & Drysdale, Harrison Cohen and Daniel Berman of the Joint Tax Committee, Bin Srinidhi of Rutgers, Robert Halperin of Fordham, Barbara Rollinson and Warren Crowdus of the Treasury Department, Scott Farmer of Miller & Chevalier, Joel Williamson of Mayer, Brown & Platt, and James Carter of the Organization for International Investment. ■

At center, Tax Foundation Chief Tax Counsel Floyd Williams chats with members of the first panel on transfer pricing: from left, Thomas Joyce, Partner, Price Waterhouse; Buck Menssen, Staff Vice President, 3M; and Catherine Porter, Partner, Miller & Chevalier.

Professor Joshua Ronen of New York University explained the theory of transfer pricing from an economist's perspective.

Congressional staffers of tax-writing committees: Bob Oswald from the office of Representative Willis Gradison, Judy Hill from the office of Senator Orrin Hatch, and Joe Gale from the office of Senator Daniel Patrick Moynihan.

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November 18, 1992

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